No. 18449

UNITED STATES COURT OF APPEALS

FOR THE NINTH CIRCUIT

****

WESTERN CREDIT COMPANY, INC.,
A corporation,

Appellant and Petitioner,

-vs-

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

****

APPELLANT'S BRIEF

****

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PLEADINGS AND JURISDICTIONAL FACTS

This appeal and petition is for a review of a decision of the Tax Court of the United States determining that appellant and petitioner (hereinafter called "petitioner") is a personal holding company, and is deficient in total personal holding company taxes for the period January 1, 1949 through April 30, 1956 in the principal sum of $32,014.36. The statutes involved are those relating to personal holding companies being Sections 500, et seq, Revenue Code of 1939, and Sections 541, et seq, Internal Revenue Code of 1954.

Notice of deficiency was issued by respondent on May 21, 1959 (Tr. 7-31). On August 17, 1959, petitioner filed its petition in the Tax Court for a redetermination of the deficiency. Generally, the petition alleged the petitioner's income consists of less than 80% personal holding company income, and petitioner is not therefore a personal holding company subject to personal holding company taxes. The respondent's answer placed this allegation in issue. Since most of the facts of the case were stipulated, and the pleadings are not in question on this appeal, further review thereof at this point appears unnecessary.

The case came on for trial before the Tax Court, sitting at Helena, Montana, on September 26, 1961 (Tr. 41). The Tax Court issued its findings, opinion and decision on September 28, 1962 (Tr. 141). By stipulation filed with the Tax Court November 21, 1961, the parties agreed, pursuant to the provisions of 26 USC Section 7482 (b), that the petition for review of the decision of the Tax Court might be filed in this court (Tr. 161). On December 24, 1962, petitioner filed its petition for review of the Tax Court decision by this court.

STATEMENT OF THE CASE

The opinion of the tax court (Tr. 141)

contains a review of the evidence which, for the most part, is adequate for the purpose of this appeal. The parties stipulated, (Tr.34) and the trial court found, based upon the stipulation entered into by the parties, and the testimony submitted by the taxpayer on direct and cross examination at the time of trial, the following facts:

1. Petitioner was incorporated in Montana in 1948 to take over a business previously operated as a partnership by its principal incorporators, and thereafter operated as a small loan, personal finance, and mortgage loan business in the city of Great Falls. At all times, more than 50% of its stock was owned by five or fewer persons.
2. Regular United States corporation income tax returns, form 1120, were duly filed for each of the years, or taxable periods involved, but no personal holding company returns were filed at any time.
3. During the periods referred to, taxpayer operated under the general corporation statutes of Montana, the state having no law specifically regulating small loan, personal finance, or mortgage loan companies, or licensing them

as such. Montana did have statutes relating to the subject of usury, copies of which have been submitted as exhibits, All of taxpayer's income, save for a small amount of rentals, derived from the operation of this business.

4. In connection with every loan made by taxpayer, two separate charges were made. In the taxpayer's nomenclature, one of these was called a "contract charge", and one was called a "carrying charge". The contract charge amounted to $10.00 or sometimes less, on loans whose principal was not exceeding $100.00, and $15.00 or 3% of the loan principal, whichever was greater, on loans whose principal exceeded $100.00. The "carrying charge" was computed at 1% per month of the principal sum, calculated in advance, for the duration of the loan, except where the loan was less than $100.00, in which case a flat figure of $1.67 per month was substituted for the charge of 1% per month. At the time of making the loan, the nature of the contract charge was explained to the borrower (Tr. 58,59,73,79,128), the borrower agreed to pay it, and the amount thereof was added to the principal of the note.

The nature of the carrying charge was also explained to the borrower, the borrower agreed to pay it, and this sum too was added to the principal of the note, to be paid in monthly installments. The note itself provided for interest at the rate of 8% per annum, but only after maturity of each of the payments. (See exhibits 21V and 22V)

5. At the time of making the loan, these two charges were computed separately on a scratch sheet, (See exhibits 13M to 20T). These "work sheets" as they are called by taxpayer, were then placed in a folder along with the other documents relating to the loan and became part of the permanent records of the taxpayer. (Tr. 58). Thus the precise amount collected through each of these charges can always be determined from examination of taxpayer's records, and they are segregated at this point. Later on, in taxpayer's bookkeeping system, when payments were made, no distinction was made between income resulting from the contract charge and that resulting from the carrying charge, the entire sums being lumped together as "collected fees". This term "collected

fees", also includes moneys collected and immediately paid out for credit reports and similar expenses, in connection with the loans, although taxpayer also has on its books another classification shown as "miscellaneous income", which also includes certain charges, such as filing fees, made by taxpayer.

6. The amounts attributable to payments of the "contract charge", as above set out, constitute more than 20% of taxpayer's gross income. Thus if the amounts collected under this heading do not constitute personal holding company income, then taxpayer is not subject to the tax.

7. The "contract charge", the nature of which was explained to the borrower, was a charge that covered the cost of investigation and setting up the loan on the books. (Tr. 59) In making a loan the first step is the interview with the customer. This is a general overhead expense, and more than 50% of all applicants are weeded out in this first interview. (Tr. 119,126) After the interview, if it is felt that there is justification for the loan (Tr. 60), an application is filled out, and

the investigation begins. This is the procedure for which the contract charge is made. (Tr. 73) There are many types of loans, each calling for a somewhat different procedure, although certain procedures are standard in all of them. A credit report is always obtained on the applicant, sometimes through a credit exchange, which involves paying a fee for the information, (Tr. 61) and sometimes by interviewing, either personally or by telephone, of credit references, or other persons who might have information about the applicant. Sometimes long distance telephone calls, with the attendant expense thereof, are involved. (Tr. 62, 64) Where security is involved, and more than 50% of taxpayer's loans involve security of some sort, (Tr.136), the security itself must be checked, exhaustively. If it is an automobile, the bluebook value is ascertained, the car itself is inspected, the motor and serial number checked, and the condition of the car ascertained. If furniture is involved, it is inspected; (Tr. 70,71) If livestock is involved, it, too, is inspected, (Tr. 70) sometimes at considerable

expense involved in a trip out of town, (Tr.70); or if trade fixtures or equipment are involved, they are inspected, with similar expenses in connection therewith. (Tr.68) The various documents in connection with the loan, such as mortgages, releases of prior mortgages, and so on, are prepared, usually by the employees of the taxpayer, and notarial work performed. (Tr. 67,72,115) Sometimes automobile titles have to be secured, particularly where out of state titles are involved, and the procedure in such instances was described by taxpayer. (Tr. 80,81,82,83,84,116,117). In many instances, prior debts are paid off by taxpayer, and receipts obtained which sometimes involves the preparation of satisfactions of other mortgages, or releases of other obligations. (Tr. 67,64,65,66) Many times, as in the case of consolidation loans, there is a great deal of work and expense involved in ascertaining the precise amount of the applicant's various obligations, in getting them paid off, or in securing the consent of the various creditors to a monthly payment plan, which will also involve the preparation

and execution of certain instruments setting up the consolidated payment plan. (Tr. 64,65, 66,101) If actual filing fees are involved, such as the fee for filing a chattel mortgage on an automobile, the fee is collected separately, and classed by taxpayer as "miscellaneous income", but if expenses are incurred such as payment for credit reports, long distance telephone calls, notarial work, and similar expenses, they are not collected separately from the applicant, but are included as a part of the "contract charge" which is assessed on the particular loan. (Tr. 72,62,64,79,100). On most of petitioner's loans, the "contract charge" is not sufficient to cover the cost of the investigation preparatory to making the loan. (Tr. 109,110)

8. The "carrying charge", calculated at 1% per month or a $1.67 per month on loans under $100.00, also includes services of the type set forth in the preceding paragraph. (Tr. 74, 71,101) This is particularly true in the case of consolidation loans, or a trusteeship, in the latter of which taxpayer acts as agent for the borrower in the payment of his various

obligations. (Tr. 101,108) This charge also includes all expenses of collection, such as the preparation and mailing of letters requesting payment, foreclosures, tracing of borrowers who have left town, and so on. (Tr. 95)

9. Frequently, particularly in the case of loans on automobiles, insurance is obtained for the borrower, (Tr.86) and very frequently credit life insurance, for which a separate charge is made, is also secured for the borrower, either in the form of decreasing term insurance, which provides the borrower with a sufficient sum to pay off the indebtedness, or in a stipulated amount, payable at death, which will pay off the loan and provide a surplus to the borrower. (Tr. 75,117,118)

10. Taxpayer did not incorporate for the purpose of obtaining income tax benefits. (Tr. 50-54) In fact, the income taxes actually paid to the government during the periods referred to at all times exceeded the amounts that would have been paid had no corporation been formed, or had the salaries of the stockholders been raised to the point of eliminating corporate

income. (Tr.134)

11. On the death of Frank M. Wallace, one of the original incorporators of the company, in 1951, his stock descended to his widow, and two children, from whom the present owners of the corporation purchased the stock under date of July 28, 1954, under the terms of a contract which severely restricts the right of the corporation to declare dividends. (Pet. Ex.23)

12. Of all the loans made by petitioner during the periods involved, those secured by chattel mortgage constituted, on a dollar basis, from 76% to 86% and on a number of loans basis, from 53% to 67%. (Tr. 136)

SPECIFICATIONS OF ERROR

Specification of Error No. 1.

The tax court erred in failing to find that the "contract charges" of petitioner are sufficiently related to the services rendered by petitioner for which the charge was made, to exclude the "contract charges" from the definition of personal holding company income interest.

Specification of Error No. 2.

The tax court erred in concluding, in its finding and opinion, as follows (Tr.156)

"On the other hand, here the 'contract charge' is not allocated for specific services. ...."

Specification of Error No. 3.

The tax court erred in concluding in its finding and opinion as follows (Tr. 158):

"We do not believe that fees charged to borrower, whose only concern is obtaining the use of lender's money, to defray ordinary and necessary expenses incurred by the lender in conducting a small loan business are truly separable from interest."

Specification of Error No. 4.

The tax court erred in concluding in its findings and opinion as follows (Tr. 158):

"Consequently, we must conclude that at least 80% of petitioner's gross income in the tax periods involved constitute interest and personal holding company income under the applicable statutes."

ARGUMENT

Definition of Term "interest".

Section 502 of the Internal Revenue Code of 1939, and Section 543 of the Internal Revenue Code of 1954, define personal holding company income, among the types of income included as "interest". Thus the question resolves itself into a determination whether the income resulting to petitioner herein from the "contract charge" constitutes interest. If it does not, then petitioner is not subject to the tax.

The term "interest" has been many times defined. In Old Colony Railroad Company vs. Commissioner of Internal Revenue, 284, U.S. 552, 561; 52 Sup. Ct. 211, 214; 76 L.Ed 484, we find the following:

> "And as respects 'interest', the usual import of the term is the amount which one has contracted to pay for the use of borrowed money."

Commissioner of Internal Revenue v. Columbia River Paper Mills, 136 Fed. 2d 1009;

Brown-Rogers-Dixson Company v. Commissioner of Internal Revenue, 122 Fed. 2d 347;

Penn Mutual Life Insurance Company v. Commissioner of Internal Revenue, 92 Fed. 2d 962;

Attention is called to two facets of the above definition. First, "interest" is the consideration for the use of borrowed money, and second, we note the use of the word "contracted". In view of the

uncontradicted testimony that petitioner explained the "contract charge" to each borrower at the time of making the loan so that the borrower understood that the charge was not being paid for the use of money, but for the making of an investigation, among other things, we have the element of agreement between the parties that the charge referred to was not "interest", but was in fact, a charge made for services to be rendered if the loan was to be made. This testimony is buttressed, (Tr. 73,128) by the explanation made to the borrower that it was a "used" charge, and that if the loan was paid before maturity, a portion of the "carrying charge" pro-rated, would be rebated to the borrower, but that the "contract charge", having been used up by the making of the investigation, would not be rebated.

In the Columbia River Paper Mills case, supra, attention is also called to this situation, in the use of the following:

> "In short, the situation is one where the parties to the transaction, being free to contract, have agreed on the one hand to pay, and on the other hand to accept, a definitely ascertainable sum as compensation for the use of

money over a stated period of time."

In the present case, the compensation for the use of the money was the "carrying charge" made on the basis of 1% per month, when the loan was over $100.00 and on the basis of $1.67 per month, where the loan was under $100.00. This was agreed to by the parties at the time the loan was made.

Further, it is abundantly clear from the testimony of Joe H. Irwin, managing director of petitioner, that not only was the "contract charge" explained to the borrower as being a charge for services to be rendered in the nature of an investigation, but that it actually was such a charge, and that such services were actually rendered in each instance. It is unnecessary here to detail again all of the things that were done by petitioner in connection with these loans, and which gave rise to the "contract charge" we think it beyond argument that the testimony establishes that we are not dealing with a subterfuge, and that the services were actually rendered.

The tax court noted these definitions (Tr. 150) and further noted that the income tax regulation under the statutes in question states that interest "means any amounts, includable in gross income, received for the use of money loaned". It will

be immediately observed, of course, that this definition does not equate interest with gross income, and neither does it make moneys received, if included in gross income, definable as interest.

The question then arises whether, in the light of the reported decisions, petitioner is nevertheless subject to the tax on the ground that the amounts received are to be considered "interest" even though they are not such in reality.

There are two leading cases on the subject, from which all the other decisions flow. The first of these, adverse to petitioner herein, is the case of Noteman v. Welch, 26 Fed. Supp. 437, Affirmed, First Circuit, 108 Fed. 2d 206. The second, which explains, modifies, and clarifies the Noteman case, is Workingmen's Loan Association v. United States, (First Circuit), 142 Fed. 2d 359. Since these two cases come very close to being determinative of the issues of the case at bar, they require a rather close analysis.

ANALYSIS OF THE NOTEMAN CASE

Petitioner in the Noteman case operated a personal loan business under the provisions of the Massachusetts Small Loan Act, which provided, generally speaking, that on loans of $300.00 or less, an overall charge might be made "for interest and expenses" not

to exceed 3% a month to be paid by the borrower, and precluded any other charges.

Noteman, one of the trustees of National Loan Society of Boston, in accordance with this Act, charged 3% per month to the borrowers. The Collector of Internal Revenue, contending that the entire 3% was to be considered as "interest" held the company to be a personal holding company; Noteman petitioned for redetermination, and after an adverse decision, appealed, contending that he was entitled to have a portion of the moneys received under the 3% per month payment considered as charges for services rendered rather than interest. He was unsuccessful. There are some similarities to the present case, but there are also points of divergency, and in particular, one very important difference.

It is to be observed first, in analyzing the decision, that the Circuit Court held that the burden was on the taxpayer to show that more than 20% of its income, was for something other than "interest", and then after considering the circumstances of the case, the court held, not that the entire 3% was interest, but that the taxpayer had failed to sustain the burden of proof. On page 215, of the report in 108 Fed. 2d, we find the following:

"What we do say is that on the present record the taxpayer has failed to sustain the burden of proving that over 20% of its gross income was derived from sources other than interest. The trial judge could not have so found on the evidence. The taxpayer is therefore not entitled to judgment for recovery of the surtax."

On page 214, of the same report, we find the following:

"We do not say, in concluding on this branch of the case, that all payments by borrowers from licensed personal finance companies are necessarily "interest" under the Massachusetts Small Loans Law, or under Section 351 of the Revenue Act of 1934. If the loan contract calls for payments by delinquent borrowers for extra expenses of collection resulting from their own default, such payments would not be called interest. Williams v. Flowers, 1890, 90 Alabama 136, 7 So. 439, 24 Amer. St. Rep. 772. If accounts receivable are

pledged as security for the loan, an extra payment to the lender for the actual services of collecting the accounts would not be called interest. In re Mesibovsky, supra. Nothing of this sort appears in the case at bar, for the taxpayer 'taken nothing as security but a plain note or few chattels'. Perhaps notarial and recording fees for chattel mortgages, if required to be paid by the borrower, might be regarded as a charge separable from interest. ....."

We think there is an important destinction, in view of what we shall say hereinafter. It would have been one thing to hold that the entire 3% was interest, whether it was charged for the use of money or for services rendered, but it is an entirely different thing to hold that the taxpayer failed to sustain the burden of showing that more than 20% of the income was a charge for something other than the use of money. When the statute refers to "20%," it is referring to a precise proportion, not an approximation, and to arrive at a precise calculation such as this, it is necessary to have some rather precise figures

upon which to make the calculations.

In the Noteman case, the taxpayer was dealing with a lump charge of 3% per month, and he had no way of segregating precisely what part was for the use of money from the part that was charged for services rendered, even though the Massachusetts Small Loans Act provided that the 3% per month was to be "for interest and expenses". Hence, petitioner there was forced to the expedient of showing the nature of the services rendered, somewhat similar to the present case, for which separate charges were claimed, and then estimating what proportion of the total charge was to be ascribed to the services rather than the interest charge. It is clear that no matter how persuasive his testimony may have been on the subject of services rendered, his ship necessarily foundered on the rock of his inability to prove a precise figure like 20%. The great distinction from the present case lies in the fact that petitioner here is able to point out precisely, from its permanent corporate records, the amounts that were received from the "contract charge", and it has been stipulated that this amount exceeds 20% of petitioner's gross income.

To add to petitioner's troubles in the Noteman case, the Court pointed out that not only was

he unable to segregate "charges" from "interest", but that even his "charges" were a rather amorphous mass of work, some of which benefitted the borrower, but some the lender only, and that the costs or "charges" were spread across all loans and did not apply specifically to a given loan.

On this latter point, it may be argued that in the present case, since the contract charge, though applied specifically to a given loan, was only made when a loan was actually completed, the cost of investigations on loans not made would be spread across all loans. But this ignores several factors in the present case. First, there are two charges here, and the investigation costs on loans not made could just as easily, and more properly, be ascribed to the "carrying charge". Second, the testimony is that more than 50% of all applicants are weeded out at the first interview before any "contract charge" is made, and if the applicant gets into the investigation stage, the loan is usually made. Third, and perhaps most important of all, the testimony is that on most loans, the "contract charge" is not sufficient to cover the cost of the investigation. (Tr. 109) Thus, some of the investigation costs, even where the "contract charge" is collected, probably spill over

into the "carrying charge", and certainly there is no surplus in this "contract charge" which would be able to cover the cost of investigations on loans not made.

DECISIONS FOLLOWING THE NOTEMAN RULE

Following the Noteman decision, and prior to its modification as hereinafter set forth, were two other cases, decisions in which were adverse to petitioner's position here. In Virginia Loan and Thrift Corporation v. Commission, 2 T.C.M. 27, entered May 10, 1943, the income from investigation fees was held to be interest. Here the taxpayer had actually segregated his investigation fees from the other income, but the important portion of the ruling we think, is contained in the following quotation:

> "At the hearing the petitioner, through its counsel, admitted that there was no particular investigation made for which an "investigation fee" as allowed by the Virginia statute, was collected from the borrower. In other words, the charge was made as in the case of the admitted interest charge as a part of the borrower's cost of the loan."

The distinction is obvious, In the present case we are not dealing with a subterfuge as was the

case above. There actually was an investigation in our case, and it was extensive.

In United Finance Company, Inc. v. Commissioner, also in 2 T.C.M., at page 38, entered May 8, 1943, we have another holding that service charges should be considered as interest, but here again the taxpayer does not appear to have been able to segregate his income from service charges from that resulting from interest.

ANALYSIS OF WORKINGMEN'S LOAN CASE

A little over four years after the decision in the Noteman case, the same court, speaking through the same judge, with reference to the same Massachusetts Small Loan Act, decided the case of Workingmen's Loan Association v. United States, 142 Fed. 2d, 359, in an opinion which explains the Noteman decision, modifies it in certain respects, and sets forth clearly the rules which we think should govern the present petition. Among other things, the court said the following, at page 361:

> "Our holding in the Noteman case was that the taxpayer had failed to sustain the burden of proving that over 20% of its gross income was derived from sources other than interest. We

recognize, however, that charges made by lenders in connection with making loans are not necessarily all "interest", within the meaning of paragraph 351, and that the loan contracts may properly call for the rendition of certain specified services by the lender for which a separate charge is to be made in addition to interest.

"It is of course true that a borrower may have costs in connection with procuring a loan, over and above the interest charged for the use of borrowed money. He may, for example have to pay the expense of procuring a credit rating in a mercantile agency, or the fee of a certified public accountant for preparing a balance sheet, or an appraiser's fee for appraising property which he offers as security, or the fee of a lawyer for searching a title. In the case of the small individual borrower, who applies to a personal finance company for a loan, services of this nature, for which the borrower would

otherwise have to pay a third person, are not uncommonly rendered by the finance company for a separate charge in addition to interest."

Such is precisely the case at bar. Further in the case at bar, the charges for such investigation are separately calculated at the time of making the loan, and are capable of precise ascertainment. It makes no difference that in the Workingmen's case, the separate charge was called an "initial charge", for it is precisely the sort of charge that is made in the present case. The court, in considering the charge, used the following language:

"In making loans and keeping its books, the taxpayer has had the practice of separating what it regards as the interest charges from charges for services to the borrowers in investigating, identifying, inspecting, and appraising the credit and security of the borrower. A so-called "initial charge" for these separate services is made known to the borrower before the loan is consummated and is collected in advance as a flat sum which does not vary with

the duration of the loan. These initial charges, as distinguished from interest, are adjusted to the nature of the loan. In the case of unsecured loans, the borrower makes an initial payment of $3.00 to $5.00 depending upon the size of the loan, plus an additional sum equal to 2% of the face of the note. In the case of secured loans there is an initial charge of $5.00, plus an additional charge varying between 2% and 7%, depending upon the type of security involved. The interest rate, as distinguished from the initial charge, is 1% per month on the unpaid balance, this is the only charge mentioned in the form of promissory note executed by borrowers from the taxpayers.

It is to be emphasized that these initial charges are adjusted to the amount and type of loan, secured or unsecured, and are specifically allocated, by agreement with the borrower to the expense of 'investigation, identification, inspection

> and appraisal.' They are 'the customary and usual charges made by concerns engaged in business similar to that conducted by the plaintiff.' They are paid in advance, and do not depend upon the duration of the loan, whereas in the Noteman case the blanket charge for 'expenses', was fixed at 2% per month on the unpaid balances and ran along during the whole life of the loan. There was no suggestion that the present taxpayer's charges for specific initial services were excessive and a mere device for concealing an exaction not permitted by law."

Neither is there any suggestion that Western Credit Company's "contract charge" is excessive, or a mere device for concealing an exaction not permitted by law. The similarities are striking. Western Credit, too, separates on its books, in the form of its work sheets, what it regards as the interest charge from charges for services to borrowers in investigation, identifying, inspecting, and appraising the credit and security of the borrower. The charge is collected in advance

as a flat sum, by being added to the principal of the note, and it does not vary with the duration of the loan. In each case an entirely separate charge of 1% per month was made on the unpaid balance. This, among other things, is the interest on the loan.

It will be recalled that in the present case the contention is made by taxpayer that even the "carrying charge" contains some elements of services rendered rather than being all interest. That this is true is demonstrated by the testimony of petitioner (Tr.73) and hence the "carrying charge" did not constitute "interest" only. The court will also note (Tr.45, 46) that counsel for petitioner conceded that in view of the authorities, the segregation into its component parts of this "carrying charge" could not be made. Reference at the time was made to the distinction between the Noteman case and the Workingmen's case. We feel that the "carrying charge" of petitioner is analogous to the 3% a month charge considered by the court in the Noteman case, and is therefore subject to being considered all "interest", whether such is the reality or not, but that the "contract charge" is precisely analogous to the "initial charge" being considered in the Workingmen's case.

OTHER APPLICABLE DECISIONS

It will be observed, we think, in following out the other cases relating to the subject, that the ability of the taxpayer to segregate his charges is usually, if not always, the controlling factor.

Another case, which at first blush appears to be contrary to the position taken here by petitioner, but which on analysis proves to be distinguishable, is that of Girard Investment Company v. Commissioner, 122 Fed. 2d 843. Here too, it is clear from the overall language of the opinion, that the petitioner was unable to segregate the specific amounts charged for services rendered from those charged as interest, and because of this the taxpayer was caught in the same web as was spun in the Noteman case. For instance, the court says the following:

> "Learned counsel, who argued the case as amicus curiae in that case, (referring to Noteman) may have given, and no doubt has given some polish to his earlier contentions. They are, however, in essence the same, and we think, should receive the reception previously accorded. Counsel maintained then and now: first, that the return charged

for the use of money loaned in small amounts is not interest; second, that the plain and specific words of the act are over-ridden by a general intention not to apply them to operating companies; and third, that a subsequent amendment is clarifying rather than altering."

Not one of these contentions is advanced by present petitioner. Our contention is that taxpayer made a separate charge for services rendered, and that charge is not interest. We submit that had counsel in the Girard case been able to make the distinction that can and is being made here, he would have done so, and the arguments which the above quotation indicates he made, would have been unnecessary.

In the Girard case the court also says:

"With many small loans to the kind of people who need small sums, the effort of administration and the insecurity of payment is more pronounced. The small loan companies have advocated and been granted rates covering this increased cost and risk. It is a non sequitur to use this justifiable excess in nominal

> interest as in argument in support of its own exclusion from the general word "interest" and the limitation of that word to pure "interest".

The foregoing is clearly true, but it does not apply to the present case. If, because of the effort of administration and the greater risk, a greater rate of interest is allowed and charged, it is perfectly true that the nature of the charge is not changed by being made greater. But where something entirely different is done, whether for the same reasons or others, and an entirely separate and distinct charge is made, called a "contract charge" in the nature of a flat charge for investigating the risk, and other services, then the separate charge is exactly what it is called, and it isn't interest.

A fourth case, which in the circuit court went adversely to the taxpayer, but which upon examination proves rather favorable to the present petitioner, is that of Bond Auto Loan Corporation v. Commissioner, 153 Fed 2d, 50. Here a Missouri statute provided that when a loan was secured by a chattel mortgage on a motor vehicle, because of the extra hazards involved in such loans, the corporation might, in addition to the regular 8% interest charge, exact a charge not greater

than $20.00. The statute also provided that if the company retained any part of the fee for its own use, the note evidencing the indebtedness should bear a statement that the maker had the option of conveying to the lender the vehicle securing the note, regardless of its condition, in full satisfaction of the balance due. The question arose whether these extra hazard charges were to be considered as interest or as something else. The taxpayer contended that the extra hazard charge was not paid by the borrower for the use of the money borrowed, but was paid for the contractual right to satisfy the loan by delivering the automobile to the lender. The court rejected this, holding that the extra hazard charge was additional interest.

Significant in the case is the breakdown of the taxpayer's income. We find the following language:

> "A breakdown of the gross income of the corporation for the fiscal year ending April 30, 1939, discloses that a total of 9.14% of the corporation's income was derived from the regular 8% interest allowed by Missouri law, that 18.06% was derived from examination and investigation fees, that 71.11% was derived from

the extra hazard charges, and that 1.69% was from miscellaneous items."

We feel that the court quite properly held that the extra hazard charges were in reality additional compensation for the use of money. The court used the following language:

"The corporation's business is that of a money lender, not an insurer. It would seem strange, that, of its total gross income for the year ending April 30, 1939, only 9.14% thereof was received for the use of money loaned, and 71.11% was received for insuring its borrowers against the possibility of a deficiency judgment. The extra charges appear to be authorized primarily for the benefit of the lender, not the borrower."

On page 51, the court also used the following language:

"We are convinced that the extra hazard charges which constituted such a large percentage of the corporation's total income for the taxable years, were received for the use of money loaned. The fact that in order to be

permitted to retain for itself any part of the extra charges exacted, the Missouri law required the corporation to agree to accept the security in full settlement of the indebtedness and that the corporation complied with that law does not alter this conclusion. The extra charge is authorized 'on account of the extra hazards involved in such loans.' In other words the charge is authorized because of the extra hazard to the lender in making such loans. The Missouri statute does not authorize extra charge in consideration of the option. It authorizes it in recognition of insufficiency of an 8% interest rate, and protects the borrower to the extent that, having paid the additional charge, he will not subsequently be subject to a deficiency judgment in the case of foreclosure of his security."

All of the foregoing seems persuasive to us. At the same time, it also seems persuasive to us that the plain implication of the case is that the 18.06% of the taxpayer's income which was derived from examina-

tion and investigation fees was not interest income. This seems to have been tacitly accepted by all of the parties to the case. It is also to be observed that since 18.06% of the income was segregaged as being derived from examination and investigation fees, there was scarcely anything else that the 71.11% could be called, except interest.

In the present case, a figure in excess of 20% of petitioner's gross income, by stipulation, derives from the "contract charge" which from the testimony clearly appears to have been a charge for examination and investigation, and other services rendered to the borrower in connection with his qualifying for the loan. It is similar to the 18.06% in the Bond case, which tacitly was not included in the term "interest."

SPECIFICATION OF ERROR NO. 1

In arriving at its decision for respondent and against petitioner, the Tax Court imposed upon petitioner a burden of proof far beyond that which the First Circuit Court laid down in either the Noteman or the Workingmen's case. Having in mind that the testimony and evidence in this case was uncontroverted, the Tax Court in effect recognized that practical distinctions were more of form than of substance between the Workingmen's case and the case at

bar, (Tr. 156) and then proceeded in the balance of the opinion (Tr. 156-159) to conclude that the "contract charge" in this case was not sufficiently related to the services performed by the petitioner in investigation and setting up the loan, to justify the exclusion of the "contract charge" from interest. For instance, the Tax Court concluded (Tr. 157-158) "the evidence provides no basis for determining the costs of performing services that can clearly be said to be rendered for the borrower as distinguished from the general costs of operating a business of this nature." Yet, the uncontroverted record is that the borrower was informed what the contract charge was being used for, and that on most loans the expense of the investigation for which the contract charge was made, exceeded the amount of the charge. We do not see how the petitioner could have more clearly sustained the burden of proof laid down in the Workingmen's case, than it did under the circumstances. The Tax Court, actually, seems to be impelled to the idea that petitioner must prove its case beyond a reasonable doubt in that the "contract charge" must have an exact, unalterable, direct, specific relationship to the particular services rendered a particular borrower with respect to a particular loan. This is not the rule of either the Noteman

or the Workingmen's case, and a taxpayer is not held to any such strict burden of proof as that which the Tax Court apparently deemed essential to a determination of the case in favor of the petitioner. Although the tax court did not expressly say so in its opinion, the net result of the decision is that, in order to beat the burden the Tax Court imposes upon a taxpayer under the decision in the case at bar, the lender would have to precisely account for the actual disbursement of the "contract charge" in the course of its business. In essence, the tax court would have the taxpayer prove his case by showing, not only what the charge was made for but in addition, specifically and precisely how it was spent. If, petitioner's evidence as to utilization of the contract charge had been controverted, so that there was an issue before the court respecting how and for what the "contract charge" was actually utilized, there might be some justification for sustaining more particular proof in this case. Where utilization of the "contract charge" was shown to be less than the expenses toward which the same was directed, and further shown to be a reasonable charge for the services entailed, the Tax Court was not entitled to insist that the petitioner show more than it already had with respect to the utilization of the

contract charge.

In finding as it did in this connection, it seems to us that the Tax Court has ignored one of the most basic and fundamental rules of statutory construction, namely, that a tax statute should be construed most favorably to the taxpayer. In the Old Colony Railroad case, supra, 52 Sup. Ct., on page 214, we find the following:

> "If there were doubt as to connotation of the term, and another meaning might be adopted, the fact of its use in a tax statute would incline the scale to the construction most favorable to the taxpayer. (citing cases)"

If the undoubted rule of statutory construction is to be followed, it would seem that the tendency should be to relax, rather than restrict, the tentacles thrown about the unfortunate taxpayer by the Noteman decision.

SPECIFICATION OF ERROR NO. 2

One of the distinctions which the tax court attempted to make between the case at bar and the Workingmen's case, was that in the present case, the "contract charge" was not allocated for specific services, whereas in the Workingmen's case the equivalent charge in that case was specifically "allocated by

agreement with the borrower, to the extent of 'investigation, identification, inspection and appraisal'" of the credit and security of the borrower (Tr. 156). The court goes on to observe that such distinctions are more imaginary than real, and more of form than substance, unless it is shown that the charge was actually used to cover the cost of the services specified, and those specified are services to the borrower rather than to the lender or services normally required in the operation of a small loan business. On the evidence of the case at bar, the tax court was not justified in attempting to observe any distinction between this case and the Workingmen's case since, in the case at bar, the "contract charge" was also explained and agreed to by the borrower. This casual distinction, coupled with the Tax Court's observation which followed, to the effect that these differences are more of form than substance unless it is shown that the charge is actually used to cover the cost of the services specified, emphasizes the unwillingness of the Tax Court to be persuaded by the weight of the evidence, unless the evidence prove petitioner's case beyond the shadow of any doubt. For, as we have indicated, under the discussion of the preceding specification of error, the uncontroverted record was that

the "contract charges", agreed to by the borrower, were directly related to the expenses of investigation and setting up the loan, and in fact, in most cases were insufficient to cover this expense. It appears, in this regard, that the Tax Court in effect is holding that after the Workingmen's case is considered as having modified the Noteman case, forever after every possible taxpayer in a similar situation, in order to prevail must prove exactly the same circumstances, word for word, as were present in the Workingmen's case. If even a minor difference can be found, so minuscule as to require almost a microscope to discover, then the subsequent taxpayer will not be considered as falling within the rule of the Workingmen's case, but rather within the rule of the Noteman case.

SPECIFICATION OF ERROR NO. 3

The conclusion of the Tax Court which is the subject of specification of error No. 3 furnishes perhaps the most obvious point at which the Tax Court departed from the burden of proof rule laid down in the Workingmen's case, and imposed a much greater burden of proof upon the petitioner. It is apparent that, at this point in the opinion, the Tax Court abandoned serious consideration of the rule of the Workingmen's case in stating, as it did, that the Tax

Court did not believe that fees charged to a borrower whose only concern is obtaining the use of lender's money, todefray ordinary and necessary expenses incurred by the lender in conducting a small loan business are truly separable from interest. This statement by the Tax Court, if it goes unchallenged, destroys completely the effect of the burden of proof rule in the Workingmen case. In substance, the Tax Court has said that all of the expenses attributable to making a loan are the business expenses of the lender, and all payments made by the borrower whose only concern is obtaining the use of the lender's money, are necessarily included in interest. This premise would make it absolutely impossible for any lender to receive from any borrower, anything other than interest, regardless of the contractual intention or understanding of the parties. The Tax Court, in effect, by this statement is striking down the definition of the term "interest" laid down in the Old Colony case cited, supra, page 13 and establishes that a lender and a borrower have no right to contract except for a payment of interest by the borrower to the lender. Yet, a proper definition of "interest", as seen hereinabove, is that "interest" is actually that amount of money which the parties contract to pay for the use of

the money. It is a platitude to suggest the borrower's only concern is obtaining the use of the lender's money. This is always so, and the statement begs the question, since the issue is not the fact that the borrowers only concern is obtaining the use of the lender's money, but the question of the amount of money which the borrower contracted to pay for the use of the money borrowed. It was likewise inaccurate for the Tax Court to conclude that the charges were to defray the ordinary and necessary expenses incurred by the lender in a small loan business and are not separable from interest since, as we have indicated, the charges made by the petitioner which constituted the contract charges either had to be paid by the borrower, performed and paid for by a third party, or paid by the lender, or else there would be no loan.

We see no essential difference between this situation and the situation where an owner of a home tries to borrow money, using the home as security. Money is paid for the examination of an abstract, where abstracts are used as is the case in Montana, and also for bringing the abstract down to date. Money is paid for the drafting of a mortgage and note and such other documents as may be indicated by the particular circumstances. If the loan happens to be a Federal Housing

Administration loan, an appraisal must be made by the FHA, and payment must be made therefor. All of these items are paid by the borrower, but so far as we have heard to date, nobody has as yet called them interest. It is clear therefore, that monies paid by a borrower are not necessarily interest, but can be, and frequently are, charges for services rendered. Particularly is this so where, as in the present case, the nature of the charge is explained to the borrower before he borrows the money. If he does not want to pay the charges he can simply go elsewhere for his loan. They are voluntarily paid by the borrower, with full knowledge that they are charges for an examination of the credit risk, and not as interest.

An interesting contrast to the attitude of the Tax Court here in attempting to broaden the definition of "interest" to the detriment of the taxpayer was the finding of the Tax Court in Elk Discount Corporation v. Commissioner, 4 TC 196, Decision, 14,179 October 17, 1944. In this latter case, the petitioner was in the business of purchasing conditional sales contracts covering automobiles sold by dealers, who when they sold the car took a cash down payment and a contract for the balance, which contract obviously included interest charges on the unpaid

balance to be paid by the automobile purchaser. Notwithstanding the undoubted fact that there was an element of interest in the amounts later paid by the purchaser of the automobile, whether paid to the automobile dealer or to the petitioner Elk Discount Corporation, the tax court held that no part of these payments were "interest" within the meaning of the personal holding company statutes. This decision cites several other holdings to the same effect and in arriving at its decision, quotes from Gould v. Gould 245 U.S. 151, in which the court stated:

> "In the interpretation of statutes levying taxes, it is the established rule not to extend their provisions, by implication beyond the clear import of the language used, or to enlarge their operations so as to embrace matters not specifically pointed out. In case of doubt they are construed most strongly against the government and in favor of the citizen."

In the instant case, in holding as it did, the tax court, it seems to us, completely disregarded the above rule, and erred in concluding it was entitled to strike down the law of contract between a borrower

and a lender through the medium of increasing the lender's burden of proof in this case.

SPECIFICATION OF ERROR NO. 4

This specification goes to the ultimate conclusion of the Tax Court that 80% of petitioner's gross income, which included the "contract charges", constituted "interest" and thus personal holding company income. If petitioner's specifications of error preceding this specification, or any one of them, is well taken, then the ultimate conclusion of the Tax Court is incorrect. Since the parties stipulated and the court find that the "contract charges" were more than 20% of the petitioner's gross income for the period involved, a determination by this court on review that petitioner sustained its burden of proof in showing that the "contract charge" was not an amount paid for the use of money, would render the Tax Court's conclusion erroneous.

CONCLUSION

Petitioner respectfully submits that, upon the uncontroverted facts and the applicable authorities, petitioner sustained its burden of proving that its "contract charges" which constitute more than 20% of its gross income, was not amounts agreed to be paid for the use of money, do not constitute personal

holding income interest and that, for these reasons, the court below erred in the manner specified. Appellant respectfully urges that this court upon review of the record and in the light of the foregoing discussion enter its order reversing the decision of the Tax Court in this case and determining the petitioner is not liable for the tax deficit claimed by the Commissioner.

Respectfully submitted,

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By Randall Swanberg
OF COUNSEL

CERTIFICATE

I certify that, in connection with the preparation of this brief, I have examined Rules 18 and 19 of the United States Court of Appeals for the Ninth Circuit, and that, in my opinion, the foregoing brief is in full compliance with those rules.

D. Randall Swansberg

ATTORNEY

AFFIDAVIT OF MAILING

STATE OF MONTANA)
: ss
County of Cascade)

GLORIA SKULRUD, being first duly sworn upon her oath, deposes and says: that she is and was on the 23 day of April, 1963, over the age of eighteen years and not a party to the within action; that there is a regular communication of mail between Great Falls, Montana, and Washington, D. C. in which latter place Mr. Louis F. Oberdorfer has and maintains his offices; that there is a regular communication of mail between Great Falls, Montana and Washington, D. C. in which latter place Mr. Crane C. Hauser also has and maintains his offices; that on the 23 day of April, 1963, she deposited in the United States mails at Great Falls, Montana, true and correct copies of the Appellant's Brief in a postage prepaid envelope securely bound to:

Mr. Louis F. Oberdorfer
Ass't Attorney General
Tax Division
U.S. Department of Justice
Washington 25, D. C.

Mr. Crane C. Hauser
Chief Counsel
U.S. Treasury Dept.
Internal Revenue Service
Washington 25, D.C.

Gloria Skulrud

SUBSCRIBED AND SWORN to before me this 23 day of April, 1963.

Mary F. Kelly

Notary Public for State of Mont
Residing at Great Falls, Montana
My Commission expires: 3-16-6[illegible],